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In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1396

WILLIAM J. ROCHELLE, JR., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. Supp. App. 1-12) is reported at 371 F. Supp. 224. The opinion of the court of appeals (Pet. App. A-3 to A-25) is reported at 521 F.2d 844. The court of appeals' amendment to its opinion on rehearing (Pet. App. A-27 to A-28) is reported at 526 F.2d 405.

JURISDICTION

The judgment of the court of appeals on rehearing was entered on January 26, 1976 (Pet. App. A-26). The petition for a writ of certiorari was filed on April 2, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the government may set off a claim for unpaid taxes of a partnership against a debt it owes the estate of

a bankrupt partner pursuant to Section 68 of the Bankruptcy Act when the tax claim is subordinate to the claims of creditors of the partner in his individual capacity under Section 5g of the Bankruptcy Act.

STATUTES INVOLVED

Section 68 of the Bankruptcy Act, 30 Stat. 565, as amended, 11 U.S.C. 108, is set forth at pp. 3-4 of the petition. Because there are various errors in the reproduction of Section 5g of the Bankruptcy Act, 30 Stat. 548, as amended, 11 U.S.C. 23(g), in the petition (p. 3), we set forth that provision below:

> §23. Partners.
>
> (g) The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in the proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the State applicable thereto.

STATEMENT

Angus G. Wynne, Jr., and Compass Fair, Inc., a New York corporation, formed a New York partnership, Wynne-Compass Fair, Inc., to operate the Texas pavilion at the 1964 New York World's Fair. The partnership proved unsuccessful, and on July 16, 1964, Wynne-Compass

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filed a petition for an arrangement of its debts under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 *et seq.*, in the United States District Court for the Southern District of New York. The partnership continued to operate its business as a debtor in possession until August 18, 1964, when it was adjudicated a bankrupt (Pet. App. A-4 to A-5; R. 12-13).[1]

During its operations, Wynne-Compass incurred liability for the employee's portion of Federal Insurance Contribution Act (F.I.C.A.) and income taxes, the employer's portion of F.I.C.A. taxes, Federal Unemployment Tax Act (F.U.T.A.) taxes, and excise taxes (Pet. App. A-5; Supp. App. 2 and n. 3). In September 1964, involuntary bankruptcy proceedings were filed against Wynne in the United States District Court for the Northern District of Texas, and Wynne was adjudicated a bankrupt two months later. The government thereafter filed proofs of claim for $349,679.02 in unpaid employment and excise taxes owed by Wynne-Compass in the bankruptcy proceedings of both the partnership and Wynne (Pet. App. A-5).

As a result of the unsuccessful operation of the partnership, Wynne had a net operating loss for 1964. Pursuant to Section 172 of the Internal Revenue Code (26 U.S.C.), Wynne was eligible to "carry back" the 1964 loss to 1962 and receive a $325,380.97 tax refund for the earlier year. In 1968, petitioner, as trustee of Wynne's bankrupt estate, filed a claim for refund for this amount. Although the government allowed the claim for refund, it retained the tax refund as a set-off against the unpaid tax liability of the

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[1] "R." refers to the record appendix in the court of appeals.

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partnership under Section 68a of the Bankruptcy Act, (11 U.S.C. 108(a)) (Pet. App. A-5; R. 14-16).[2]

Petitioner thereupon instituted these refund suits which were consolidated. The district court upheld the government's right to set-off Wynne's tax refund against the partnership tax liability (Pet. Supp. App. 1-12). The court of appeals affirmed (Pet. App. A-1 to A-25). It first concluded that because the government's tax claims originated in the operation of the partnership, they were subordinate to the claims of creditors of Wynne in his individual capacity, under Section 5g of the Bankruptcy Act (11 U.S.C. 23(g)). However, the court held that Wynne's claim for a tax refund and the government's claim for taxes were mutual debts under Section 68a of the Bankruptcy Act so that set off of the two claims was proper (Pet. App. A-6 to A-25).[3]

ARGUMENT

1. Section 68a of the Bankruptcy Act provides that in all cases of mutual debts between the estate of a bankrupt and a creditor, "the account shall be stated and one debt

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[2]Although petitioner had originally agreed in writing to such a setoff when he filed the claim for refund in 1968 (Pet. App. A-5, n. 4), he subsequently contended that he had not intended to waive his right to the tax refund as trustee of Wynne's bankruptcy estate. The district court held that petitioner was estopped from repudiating his earlier agreement (Pet. Supp. App. 9-10). In light of its disposition on the merits, the court of appeals did not consider the issue of estoppel (Pet. App. A-5, n. 4, A-25).

[3]Because a portion of the government tax claims against the partnership represented pre-petition penalties, the court of appeals remanded the case to the district court for a determination of the amount of the penalties that were satisfied in the set-off. The government had conceded that such penalties were not allowable claims in bankruptcy, and that a refund of the penalties was proper (Pet. App. A-27 to A-28).

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shall be set off against the other, and the balance only shall be allowed or paid." Set-off against the bankrupt's estate requires that the debts running between the bankrupt and the creditor asserting the right of set-off be mutual, and that the debt the bankrupt owes the creditor be provable against the estate of the bankrupt and allowable under Section 57g of the Bankruptcy Act (11 U.S.C. 93(g)). 4 Collier on *Bankruptcy*, par. 68.04[1] (14th ed., 1975).

The decision below correctly held that set-off was appropriate in this case. As the court of appeals observed (Pet. App. A-19 to A-20), petitioner has never asserted that the government's tax claims were not provable against Wynne's estate under Section 63 of the Bankruptcy Act (11 U.S.C. 103), or that they were not allowable under Section 57g. Moreover, the government's tax claims and the bankrupt's claim for a loss-carryback tax refund were "mutual debts" within the meaning of Section 68a.

It is well established that for purposes of Section 68 of the Bankruptcy Act, debts are mutual when they are "between the same parties, standing in the same capacity." 4 Collier on *Bankruptcy, supra,* at par. 68.04 [2.1]. Here, the debts satisfy this requirement. Wynne had become individually liable for the taxes incurred by his partnership prior to his bankruptcy (Pet. App. A-6 to A-8), and he had also accrued a claim for a loss-carryback tax refund of his 1962 income taxes by virtue of his share of the partnership losses incurred in 1964. See *Segal* v. *Rochelle,* 382 U.S. 375. Thus, both the government's claim against Wynne and Wynne's claim for a tax refund against the government are claims "between the same parties, standing in the same capacity." These are therefore mutual debts subject to set-off under Section 68a of the Bankruptcy Act.

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Contrary to petitioner's argument, the fact that the government's claim for taxes is subordinated to the claims of individual creditors of Wynne under Section 5g of the Bankruptcy Act does not require a different result.[4] As the court of appeals correctly stated (Pet. App. A-24), nothing in Sections 68 or 5g indicates that set-off should not be allowed where the debt asserted against the bankrupt's estate is subordinated to the claims of other creditors of the estate. See *Hayden* v. *Standard Accident Insurance Co.*, 316 F.2d 598 (C.A. 9). See also *New York County Bank* v. *Massey*, 192 U.S. 138, 145-147.

Bayliss v. *Rood*, 424 F.2d 142 (C.A. 4), and *In re Brewster-Raymond Co.*, 344 F.2d 903 (C.A. 6), relied upon by petitioner, are distinguishable. In *Bayliss*, the creditors seeking to assert a set-off had expressly agreed that their debts to the bankrupt would be "without off-set" (424 F.2d at 147).[5] In *Brewster-Raymond Co.*, the government sought after bankruptcy to set-off pre-petition penalties owed by the bankrupt against monies owed the bankrupt for performing a government contract. The court rejected the government's claim for a set-off because penalties were not an allowable claim against the bankrupt under Section 57j of the Bankruptcy Act (344 F.2d at 908-909). Here,

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[4]The government did not argue below that the subordination provisions of Section 5g were inapplicable to the United States as a partnership creditor (see *Lewis* v. *United States*, 92 U.S. 618, 620-621), or that it was entitled to a statutory priority over individual creditors of Wynne's estate despite Section 5g (Pet. App. A-9, n. 7). Cf. *In re Montgomery*, C.A. 9, Nos. 75-2442, 75-2443, decided March 18, 1976.

[5]The Fourth Circuit also held in *Bayliss* (424 F.2d at 147) that the creditors would not in any event be entitled to set-off because they stood in a fiduciary capacity toward the bankrupt. Under such circumstances, it is settled that the debts are not mutual because the parties are not standing in the same capacity. Thus, set-off is not possible. See 4 Collier on *Bankruptcy*, *supra*, at par. 68.04 [2.1].

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however, as the court of appeals noted (Pet. App. A-22 to A-23), the government stands in a different position because the claim for partnership taxes is merely subordinated to the claims of individual creditors of Wynne, and is not completely disallowed from Wynne's estate.[6]

Finally, petitioner asserts (Pet. 9) that the decision below works an unfairness by permitting the appropriation of the largest asset of the individual estate exclusively for the benefit of a single partnership creditor. But the refund of taxes sought by Wynne's estate is directly attributable to the unsuccessful partnership operations during which the partnership failed to pay its taxes (R. 14). Petitioner's position would result in the anomaly that the government would be required to pay the full amount of Wynne's tax refund and thereafter assume a subordinated position among Wynne's creditors for payment of its tax claims. No legitimate interest would be served by disallowing the set-off in these circumstances. As this Court has recognized, the equitable set-off provisions of Section 68a operate to establish a lawful preference of one creditor over others. *New York County Bank* v. *Massey*, *supra*, 192 U.S. at 146-148; *Cumberland Glass Co.* v. *De Witt*, 237 U.S. 447, 454-455. See also *In re Sherman Plastering Corp.*, 346 F.2d 492, 493 (C.A. 2).

2. Petitioner further argues (Pet. 8) that the decision below conflicts with *In re Neaderthal*, 225 Fed. 38 (C.C.A. 2), certiorari denied *sub nom. Freundlich* v. *Eisenbach*, 238 U.S. 635. There, the court refused to permit a creditor of a bankrupt partnership to set-off a debt it owed one of the partners on the ground that the debts were not mutual (225 F.2d at 39). However, the mutuality analysis of *Neaderthal*

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[6]Indeed, the government conceded that pre-petition penalties assessed against the partnership were not to be set off against Wynne's tax refund. See n. 3, *supra*.

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is no longer viable authority in the Second Circuit. In *In re Sherman Plastering Corp., supra*, 346 F.2d at 495, that court expressly "chose not to follow" that aspect of *Neaderthal*. Indeed, the mutuality analysis of *Sherman Plastering*, in which a surety under a joint and several obligation to a debtor in possession was held to be able to set-off a claim against the debtor in possession arising out of a prior transaction in which it was a surety for the debtor, is fully in accord with the decision below.

There is, moreover, no conflict with *Sherman Plastering*. While the court there suggested that the set-off of a partnership debt against a debt owed to one of the partners would be unfair to the individual creditors of the bankrupt partner, that statement, as the court of appeals here noted (Pet. App. A-21, n. 22), was dictum. *Sherman Plastering* did not involve a partnership and therefore did not concern the interplay between Sections 5g and 68a. Thus, as the court of appeals correctly concluded (Pet. App. A-21), "[n]o court has ruled on this precise point * * *."

3. Petitioner further contends (Pet. 11-14) that the decision below is erroneous insofar as it permits the government to set-off against Wynne's claim for refund of the taxes incurred by Wynne-Compass while it operated as a debtor in possession. Petitioner asserts that Wynne is not individually liable for those taxes because Wynne was not a partner of the debtor in possession.

Petitioner's assertion that Wynne was not a partner of the debtor in possession is erroneous. To be sure, a debtor in possession has a status separate from and additional to its status as the debtor. See generally 8 Collier on *Bankruptcy*, pars. 6.25-6.32 (14th ed., 1975). The debtor in possession is responsible for the operation of the business under the supervision of the court, while the debtor is responsible for preparing and submitting the plan of arrangement. But here, where the partnership operated as the debtor in

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possession, both of these responsibilities devolved upon the partnership. 8 Collier on *Bankruptcy, supra,* at par. 6.31; *Cle-Ware Industries, Inc.* v. *Sokolsky*, 493 F.2d 863, 869-871 (C.A. 6), certiorari denied, 419 U.S. 829. Those such as Wynne, who are jointly or jointly and severally liable for the obligations of the debtor, are individually liable for debts incurred by the debtor while operating as debtor in possession. See Section 397 of the Bankrupty Act (11 U.S.C. 797). The partnership taxes incurred during the arrangement proceedings are therefore mutual with Wynne's tax refund claim. Thus, as applied to the facts of this case, petitioner cannot characterize the debtor in possession as a legal entity entirely separate and distinct from the partnership-debtor.

4. Finally, petitioner argues (Pet. 14-15) that even if Section 68 permits set-off of a partnership debt against a debt due one of the partners, the set-off should not be permitted until the assets of the partnership estate are exhausted. But rejection of this contention follows from the court's disposition of the question whether subordination of the government's tax claim precludes its right of set-off against Wynne's tax refund claim. If, as petitioner assumes at this juncture, Section 68a permits the set-off of a subordinated partnership claim against a bankrupt partner, the set-off principle of Section 68 is applicable whether or not the assets of the partnership estate are exhausted (Pet. App. A-25).

Moreover, there is no authority for the proposition that Section 5g requires exhaustion of the partnership estate before partnership claims can be asserted against the estates of individual partners.[7] Indeed, Section 5g ex-

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[7] *Tucker* v. *Oxley*, 5 Cranch 34, relied upon by petitioner (Pet. 15), does not support his construction of Section 5g because it antedates the enactment of the original predecessor of Section 5g.

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pressly provides that any surplus remaining in the partner's estate after satisfaction of the claims of individual creditors shall be made part of the partnership estate and be applied to the payment of the partnership debts. Under the statute, the exhaustion of the partnership estate is not a prerequisite to such a transfer of surplus assets.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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JUNE 1976.